

MORTGAGE BANKING

by

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## Definition of 'Mortgage'

A debt instrument, secured by the collateral of specified real estate property, that the borrower is obliged to pay back with a predetermined set of payments. Mortgages are used by individuals and businesses to make large real estate purchases without paying the entire value of the purchase up front. Over a period of many years, the borrower repays the loan, plus interest, until he/she eventually owns the property free and clear. Mortgages are also known as "liens against property" or "claims on property." If the borrower stops paying the mortgage, the bank can foreclose.

## Investopedia explains 'Mortgage'

In a residential mortgage, a home buyer pledges his or her house to the bank. The bank has a claim on the house should the home buyer default on paying the mortgage. In the case of a foreclosure, the bank may evict the home's tenants and sell the house, using the income from the sale to clear the mortgage debt.

Mortgages come in many forms. With a fixed-rate mortgage, the borrower pays the same interest rate for the life of the loan. Her monthly principal and interest payment never change from the first mortgage payment to the last. Most fixed-rate mortgages have a 15- or 30-year term. If market interest rates rise, the borrower's payment does not change. If market interest rates drop significantly, the borrower may be able to secure that lower rate by refinancing the mortgage. A fixed-rate mortgage is also called a "traditional" mortgage.

With an adjustable-rate mortgage (ARM), the interest rate is fixed for an initial term, but then it fluctuates with market interest rates. The initial interest rate is often a below-market rate, which can make a mortgage seem more affordable than it really is. If interest rates increase later, the borrower may not be able to afford the higher monthly payments. Interest rates could also decrease, making an ARM less expensive. In either case, the monthly payments are unpredictable after the initial term.

Other less common types of mortgages, such as interest-only mortgages and payment-option ARMs, are best used by sophisticated borrowers. Many

homeowners got into financial trouble with these types of mortgages during the housing bubble years.

## Definition of 'Mortgage Banker'

A company, individual or institution that originates mortgages. Mortgage bankers use their own funds, or funds borrowed from a warehouse lender, to fund mortgages. After a mortgage is originated, a mortgage banker might retain the mortgage in portfolio, or they might sell the mortgage to an investor. Additionally, after a mortgage is originated, a mortgage banker might service the mortgage, or they might sell the servicing rights to another financial institution. A mortgage banker's primary business is to earn the fees associated with loan origination. Most mortgage bankers do not retain the mortgage in portfolio.

## Investopedia explains 'Mortgage Banker'

Larger mortgage bankers service mortgages, while smaller mortgage bankers tend to sell the servicing rights

The distinguishing feature between a mortgage banker and a mortgage broker is that mortgage bankers close mortgages in their own names, using their own funds, while mortgage brokers facilitate originations for other financial institutions. Mortgage brokers do not close mortgages in their own names.

## 'Mortgage Broker'

An intermediary who brings mortgage borrowers and mortgage lenders together, but does not use its own funds to originate mortgages. A mortgage broker gathers paperwork from a borrower, and passes that paperwork along to a mortgage lender for underwriting and approval. The mortgage funds are then lent in the name of the mortgage lender. A mortgage broker collects an origination fee and/or a yield spread premium from the lender as compensation for its services.

## Investopedia explains 'Mortgage Broker'

A mortgage broker is not to be confused with a mortgage banker, which closes and funds a mortgage with its own funds. Mortgage brokers frequently facilitate transactions for mortgage bankers.

## Definition of 'Mortgage Originator'

An institution or individual that works with a borrower to complete a mortgage transaction. A mortgage originator can be either a mortgage broker or a mortgage banker, and is the original mortgage lender. Mortgage originators are part of the primary mortgage market.

## 'Loan Officer'

Representatives of banks, credit unions and other financial institutions that find and assist borrowers in acquiring loans. Some specialized loan officers, called loan underwriters, analyze and assess the creditworthiness of potential borrowers to see if they qualify for a loan. Loan officers usually work on either consumer or mortgage loans.

## Investopedia explains 'Loan Officer'

According to the U.S. Department of Labor's Bureau of Labor Statistics, nine out of 10 loan officers work for financial institutions.

Some loan officers are compensated through commission for the role that they play in the mortgage process. This commission, which is called origination points, is often negotiable.

## 'Origination'

The process of creating a home loan or mortgage. During the origination process, a borrower submits a variety of financial information - tax returns, prior paychecks, credit card info, bank balances, etc. - to the mortgage lender, who uses it to determine the type of loan the borrower is eligible for and what interest rate he or she will pay. The lender will also rely on the borrower's credit

report and other information to determine loan eligibility.

## Investopedia explains 'Origination'

Everyone must go through the origination process when obtaining a real estate loan, although the type of loan can vary greatly. The three most common loan types are fixed-rate, adjustable-rate and hybrid.

Fixed-rate loans carry the same interest rate for the life of the loan, adjustable-rate mortgages (ARMs) offer a rate that changes in conjunction with an index (like Treasury securities), while hybrid loans have features of both (typically they start as fixed-rate loans and convert to ARMs). In addition, some borrowers may qualify for a government loan, such as those offered by the Federal Housing Authority (FHA) and/or the Department of Veterans Affairs (VA).

These non-conventional loans are designed to make it easier for qualifying individuals to buy homes and typically feature lower qualifying ratios, as well as a lower or no down payment.

## 'Whole Loan'

A single residential or commercial mortgage that a lender has issued to a borrower and that has not been securitized. Whole loan lenders commonly sell their whole loans in the secondary mortgage market to buyers such as Fannie Mae. One reason lenders sell whole loans is to reduce their risk. Instead of holding a mortgage for 15 or 30 years and hoping that the borrower will repay the money, the lender can get the principal back almost immediately.

## Investopedia explains 'Whole Loan'

The lender no longer earns interest on the whole loans that it sells, but it gains cash to make additional loans. When the lender closes additional mortgages, it

earns money from origination fees, points and other closing costs paid by borrowers. This liquidity also makes it easier for borrowers to get mortgages. Fannie Mae will buy whole loans one at a time, but some other secondary market entities will only buy pools of whole loans. Loan pools can reduce risk as long as the pool includes loans with different risk characteristics, such as varying loan terms and credit scores. Fannie Mae reduces its risk by requiring that the whole loans it buys meet specific eligibility and underwriting criteria.

## 'Conforming Loan'

A mortgage that is equal to or less than the dollar amount established by the conforming loan limit set by Fannie Mae and Freddie Mac's Federal regulator, The Office of Federal Housing Enterprise Oversight (OFHEO) and meets the funding criteria of Freddie Mac and Fannie Mae.

### Investopedia explains 'Conforming Loan'

The term "conforming" is most often used when speaking specifically about a mortgage amount; however, the terms "conforming" and "conventional" are frequently used interchangeably. Mortgages that exceed the conforming loan limit are classified as non-conforming or jumbo mortgages.

OFHEO, which sets the conforming loan limit on an annual basis, has regulatory oversight to ensure that Fannie Mae and Freddie Mac fulfill their charters and missions of promoting homeownership for lower income and middle class Americans. OFHEO uses the October to October percentage increase/decrease in average housing prices in the *Monthly Interest Rate Survey of the Federal Housing Finance Board* (FHFB) to adjust the conforming loan limits for the subsequent year.

## Investopedia explains 'Mortgage Originator'

The primary mortgage market is highly fragmented in the United States. While there are several large firms that originate a large percentage of mortgages, there are thousands of smaller firms and individuals, which also account for a large percentage of total mortgage originations.

Tallying up what percentage of originations belong to which mortgage originator depends on how an origination is counted. A large percentage of newly originated mortgages are immediately sold into the secondary mortgage market, where they might be counted by the institution that purchases the mortgage in the secondary market as an origination, thus double-counting the origination.

### 'Third-Party Mortgage Originator'

1. A person or company involved in the process of marketing mortgages and gathering borrower information for a mortgage application. This information is then transferred or sold to the actual mortgage lender. Mortgage brokers are third-party originators.
2. A person or company that is involved in any aspect of the mortgage origination process (underwriting, closing, funding, etc.) on behalf of the actual mortgage lender.

### Investopedia explains 'Third-Party Mortgage Originator'

Third party mortgage originations frequently come under scrutiny because of third-party originator's lack of an ongoing and lasting responsibility for the mortgage. For example, once a mortgage broker has been compensated for brokering a mortgage, it no longer has any responsibility for the performance of the mortgage, whereas the lender has a continuing interest and is subject to some recourse should the mortgage default. This has led to some criticism of third-party originators for overpricing or otherwise selling loans to borrowers that they can't afford.

### Origination Points'

A type of fee borrowers pay to lenders or loan officers in order to compensate them for the role they play in evaluating, processing and approving mortgage loans. Credit history is one factor that plays a role in the amount of origination points a borrower needs to pay. Unlike the other types of points (for example, discount points), origination points are not tax deductible.

## Investopedia explains 'Origination Points'

Typically, each single origination point represents 1% of the mortgage loan. For example, if you are borrowing \$150,000 and the bank is charging you 1.5 origination points, you will end up paying \$2,250 (or 1.5% of \$150,000).

Since the amount of origination points required to be paid is not set in stone, borrowers may be able to negotiate the amount of origination points that they pay.

## 'Discount Points'

A type of prepaid interest mortgage borrowers can purchase that lowers the amount of interest they will have to pay on subsequent payments. Each discount point generally costs 1% of the total loan amount and depending on the borrower, each point lowers your interest rate by one-eighth to one-quarter of your interest rate. Discount points are tax deductible only for the year in which they were paid.

## Investopedia explains 'Discount Points'

For example, on a \$200,000 loan, each point would cost \$2,000. Assuming the interest rate on the mortgage is 5% and each point lowers the interest rate by 0.25%. Buying 2 points will cost \$4,000 and will result in an interest rate of 4.50%.

Both lenders and borrowers gain benefits from discount points. Borrowers gain the benefit of lowered interest payments down the road, but the benefit applies only if the borrower plans on holding onto the mortgage long enough to save money from the decreased interest payments. Lenders benefit by receiving cash

upfront instead of waiting for money in the form of interest payments over time, which enhances the lenders liquidity situation.

## 'Negative Points'

A cash rebate paid by lenders to a mortgage broker or the borrower for a mortgage with an interest rate above the lender's par interest rate. When the rebate is paid to the mortgage broker, it is known as a yield spread premium, and is part of the mortgage broker's compensation.

When the rebate is credited to the borrower it can be used to defray loan settlement costs. This is typically known as a no-cost mortgage. The amount credited to the borrower may not exceed loan settlement costs, and may not be used as part of the down payment.

## Investopedia explains 'Negative Points'

Negative points provide a way for borrowers with little or no money to pay the settlement costs and obtain a mortgage. However, the true economics of using negative points will depend on the borrower's time horizon.

If the borrower intends to hold the mortgage for a short period of time, it can be economical to avoid upfront costs in exchange for a relatively higher interest rate. If the borrower intends to hold the mortgage for a long period of time, it is most likely more economical to pay upfront settlement costs in exchange for a relatively lower interest rate.

## 'Mortgage Application'

A document submitted by one or more individuals applying to borrow money to purchase a real estate property. The mortgage application contains information about the property the potential borrowers want to purchase, such as its address, year built and price, as well as financial and background information

about the borrowers themselves. Lenders and underwriters use the information submitted on the mortgage application to determine whether money should be lent to the applicants and if so, how much, for how many years and at what interest rate.

## Investopedia explains 'Mortgage Application'

The mortgage application asks for financial data on each applicant, such as net worth, employment and annual income. The application also asks for applicants' Social Security numbers, current addresses, address history and other personal information so that the applicants' identities and credit histories can be verified and examined. Supporting documents, such as bank statements and pay stubs, are often also submitted along with the application.

## 'Silent Second Mortgage'

A secondary mortgage placed on an asset that is not disclosed to the lender of the original loan. Silent second mortgages are used when a purchaser can't afford the down payment required by the initial mortgage. The mortgage is silent because the original lender is unaware of its presence. In many circumstances, a silent second mortgage is a type of fraud.

## Investopedia explains 'Silent Second Mortgage'

When the original mortgage lender provides funds, the arrangement requires the borrower to provide a down payment. The fraud occurs when a second mortgage is used to fulfill the obligation of the down payment.

For example, let's say that you wish to purchase a house for \$250,000. You have secured a mortgage for \$200,000, which requires a down payment of \$50,000. However, you can't acquire the necessary funds for the down payment, so you decide to take a silent second mortgage of \$40,000. The original lender believes your down payment to be \$50,000 when it is actually only \$10,000 (\$50,000 - \$40,000). This increases the original lender's risk

because a 4% decrease in the home's value (\$10,000 / \$250,000) will wipe out your equity, but the original lender believes you are covered up to a 20% decline in prices (\$50,000 / \$250,000)

## 'Assumable Mortgage'

A type of financing arrangement in which the outstanding mortgage and its terms can be transferred from the current owner to a buyer. By assuming the previous owner's remaining debt, the buyer can avoid having to obtain his or her own mortgage.

### Investopedia explains 'Assumable Mortgage'

Buyers are typically attracted to homes with existing assumable mortgages during times of rising interest rates. This is because they can assume the seller's mortgage, which was created when interest rates were lower, and use it to finance their purchase.

However, if the home's purchase price exceeds the mortgage balance by a significant amount, the buyer will either need to provide a sizable down payment or obtain a new mortgage anyway. For example, if a buyer is purchasing a home for \$250,000, and the seller's assumable mortgage only has a balance of \$110,000, the buyer will need a down payment of \$140,000 to cover the difference, or will have to get a separate mortgage to secure the needed funds.

## 'Underwater Mortgage'

A home purchase loan with a higher balance than the free-market value of the home. This situation prevents the homeowner from selling the home unless s/he has cash to pay the loss out of pocket. It also prevents the homeowner from refinancing in most cases. Thus, if the homeowner wants to sell the home because s/he can't afford the mortgage payments anymore, perhaps because of a job loss, the home will fall into foreclosure unless the borrower is able to renegotiate the loan.

## Investopedia explains 'Underwater Mortgage'

Underwater mortgages became commonplace in the aftermath of the 2000s housing bubble burst, and, combined with a bad economy, resulted in numerous foreclosures. In nonrecourse states, where mortgage lenders can't pursue borrowers for more money once their homes have foreclosed, many borrowers who could still afford their mortgage and other bill payments strategically defaulted on their underwater mortgages because they believed they were cutting the losses from a bad investment.

## 'Subprime Mortgage'

A type of mortgage that is normally made out to borrowers with lower credit ratings. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a rate that is higher than a conventional mortgage in order to compensate themselves for carrying more risk.

## Investopedia explains 'Subprime Mortgage'

Borrowers with credit ratings below 600 often will be stuck with subprime mortgages and the higher interest rates that go with those mortgages. Making late bill payments or declaring personal bankruptcy could very well land borrowers in a situation where they can only qualify for a subprime mortgage. Therefore, it is often useful for people with low credit scores to wait for a period of time and build up their scores before applying for mortgages to ensure they are eligible for a conventional mortgage.

## 'Conventional Mortgage'

A type of mortgage in which the underlying terms and conditions meet the funding criteria of Fannie Mae and Freddie Mac. About 35-50% of mortgages, depending on market conditions and consumer trends, are conventional

mortgages. In other words, Fannie Mae and Freddie Mac guarantee or purchase 35-50% of all mortgages. Conventional mortgages may be fixed-rate or adjustable-rate mortgages.

## Investopedia explains 'Conventional Mortgage'

The secondary market for conventional mortgages is extremely large and liquid. Most conventional mortgages are packaged into pass-through mortgage-backed securities, which trade in a well-established forward market known as the mortgage TBA (to be announced) market. Many conventional pass-through securities are further securitized into collateralized mortgage obligations (CMOs).

## 'Residential Mortgage-Backed Security (RMBS)'

A type of mortgage-backed debt obligation whose cash flows come from residential debt, such as mortgages, home-equity loans and subprime mortgages. A residential mortgage-backed security is comprised of a pool of mortgage loans created by banks and other financial institutions. The cash flows from each of the pooled mortgages is packaged by a special purpose entity into classes and tranches, which then issues securities and can be purchased by investors.

## Investopedia explains 'Residential Mortgage-Backed Security (RMBS)'

Residential mortgage-backed securities and commercial mortgage-backed securities serve as the foundation for other financial instruments, such as collateralized mortgage obligations (CMO). Their complexity depends on the income provided to investors and the amount of risk that investors assume. A pass-through style of RMBS allows an investor to receive a share of interest and principal payments, while a CMO may have a structure that allows investors to assume more risk but also potentially more return.

Investing in a residential-mortgage backed security can expose the investor to prepayment risk and credit risk. Prepayment risk is the risk that the mortgage

holder will pay back the mortgage before its maturity date, which reduces the amount of interest the investor would have otherwise received. Prepayment, in this sense, is a payment in excess of the scheduled principal payment. This situation may arise if the current market interest rate falls below the interest rate of the mortgage, since the homeowner is more likely to refinance the mortgage.

Residential mortgage-backed securities are considered one of the precipitating factors in the 2007-2008 financial crisis. Investors in RMBS and other mortgage-backed derivatives were exposed to an increase in foreclosures and falling home prices, as well as falling interest rates.

### 'Commercial Mortgage-Backed Securities (CMBS)'

A type of mortgage-backed security that is secured by the loan on a commercial property. A CMBS can provide liquidity to real estate investors and to commercial lenders. As with other types of MBS, the increased use of CMBS can be attributable to the rapid rise in real estate prices over the years.

### Investopedia explains 'Commercial Mortgage-Backed Securities (CMBS)'

Because they are not standardized, there are a lot of details associated CMBS that make them difficult to value. However, when compared to a residential mortgage-backed security (RMBS), a CMBS provides a lower degree of prepayment risk because commercial mortgages are most often set for a fixed term.

### Mortgage-Backed Security (MBS)'

A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a accredited credit rating agency, and usually pay periodic

payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Also known as a "mortgage-related security" or a "mortgage pass through."

## Investopedia explains 'Mortgage-Backed Security (MBS)'

When you invest in a mortgage-backed security you are essentially lending money to a home buyer or business. An MBS is a way for a smaller regional bank to lend mortgages to its customers without having to worry about whether the customers have the assets to cover the loan. Instead, the bank acts as a middleman between the home buyer and the investment markets.

This type of security is also commonly used to redirect the interest and principal payments from the pool of mortgages to shareholders. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages as they are classified under the MBS.

## Definition of 'Mortgage Servicing Rights - MSR'

A contractual agreement where the right, or rights, to service an existing mortgage are sold by the original lender to another party who specializes in the various functions of servicing mortgages. Common rights included are the right to collect mortgage payments monthly, set aside taxes and insurance premiums in escrow, and forward interest and principal to the mortgage lender.

## 'Participation Mortgage'

A participation mortgage is a type of mortgage that allows the lender to share in part of the income or resale proceeds. The lender participates in the income of

the mortgaged property beyond a fixed return, or receives a yield on the loan in addition to the straight interest rate.

## Investopedia explains 'Participation Mortgage'

In a participation mortgage, the lender (mortgagee) is entitled to share in the rental or resale proceeds from a property owned by the borrower (mortgagor). The mortgage is evidenced by the bank or another fiduciary that has legal title to the mortgage and sells the fractional shares to investors or makes the investment for the certificate holders.

## Qualified Mortgage '

A mortgage in which the lender has analyzed the borrower's ability to repay based on income, assets and debts; has not allowed the borrower to take on monthly debt payments in excess of 43% of pre-tax income; has not charged more than 3% in points and origination fees; and has not issued a risky or overpriced loan like negative-amortization, balloon, 40-year or interest-only mortgage. Qualified mortgages begin in January 2014, and provide legal protections for lenders who follow certain regulations in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

## Investopedia explains 'Qualified Mortgage '

Under qualified mortgage rules, "safe harbor" provisions protect lenders against lawsuits by distressed borrowers who claim they were extended a mortgage the lender had no reason to believe they could repay. However, the rules also protect both borrowers and the financial system from the risky lending practices that contributed to the subprime mortgage crisis of 2007.

Lenders who issue qualified mortgages can resell them in the secondary market to entities such as Fannie Mae and Freddie Mac. These two government-sponsored enterprises buy most mortgages, which frees up capital for banks to make additional loans. The mortgages are then repackaged to allow investors to acquire a stake in the housing market without owning property directly. The

qualified mortgage rules are supposed to ensure that these investments are relatively safe and do not pose the type of systemic risk to the financial system that contributed to the Great Recession.

There are several exceptions to qualified mortgage rules. Points and origination fees may exceed 3% for loans of less than \$100,000 (otherwise, lenders might not be sufficiently compensated for issuing such loans, and these smaller mortgages might become unavailable). Also, small lenders, lenders who hold mortgages in their portfolios instead of selling them into the secondary mortgage market and rural lenders face fewer lending restrictions than big-bank lenders.

Qualified mortgage regulations do allow lenders to issue mortgages that are not qualified, but the rules limit the sale of these loans into the secondary mortgage market and provide fewer legal protections for lenders.

## Adjustable-Rate Mortgage - ARM'

A type of mortgage in which the interest rate paid on the outstanding balance varies according to a specific benchmark. The initial interest rate is normally fixed for a period of time after which it is reset periodically, often every month. The interest rate paid by the borrower will be based on a benchmark plus an additional spread, called an ARM margin.

An adjustable rate mortgage is also known as a "variable-rate mortgage" or a "floating-rate mortgage".

## Investopedia explains 'Adjustable-Rate Mortgage - ARM'

Both 2/28 and 3/27 mortgages are examples of ARMs. A 2/28 mortgage's initial interest rate is fixed for a period of two years and then resets to a floating rate for the remaining 28 years of the mortgage. A 3/27 mortgage is typically the same as a 2/28 mortgage, except that the interest rate is fixed for three years and then floats for the remaining 27 years of the mortgage.

## 'Two-Step Mortgage'

A mortgage that offers an initial fixed-interest rate for a period of time (usually 5 or 7 years) after which, at a predetermined date, the interest rate adjusts according to current market rates. At the adjustment date, the borrower might have the option of choosing between a fixed-interest rate (based on current market rates) for the remaining term of the mortgage, or a variable interest rate structure for the remaining term of the mortgage.

## Investopedia explains 'Two-Step Mortgage'

Borrowers who choose a two-step mortgage carry the risk that the interest rate on the mortgage will adjust upward after the fixed-interest rate period expires. This risk should be understood and measured. The interest rate cap structure of the mortgage, including the index to which the mortgage is tied and the margin, should be known and analyzed. Many two-step mortgage borrowers plan on refinancing or moving before the initial fixed-interest rate period ends, this itself is a risk known as refinancing risk.

## 'Delinquent Mortgage'

A home loan for which the borrower has failed to make payments as required in the loan documents. If the borrower can't bring the payments on a delinquent mortgage current within a certain time period, the lender may begin foreclosure proceedings. A lender may also offer a borrower a number of options to help prevent foreclosure when a mortgage becomes delinquent.

## Investopedia explains 'Delinquent Mortgage'

Foreclosure is a last resort for lenders, because it is an expensive procedure and lenders typically lose money in foreclosure proceedings. A forbearance agreement is a potential alternative to foreclosure if the borrower's financial difficulties are temporary. Under a forbearance agreement, the lender

temporarily allows the borrower to stop making payments or to pay less than the usual monthly payment.

A homeowner with a delinquent mortgage, who doesn't think his financial difficulties are temporary but who wants to avoid foreclosure, might convince the bank to agree to a short sale. This occurs when the borrower cannot sell the home because he owes more than the home is worth, so the bank agrees to allow the borrower to sell the house for less than the mortgage balance. In some states, the bank will forgive the difference; in others, the homeowner must repay the difference.

A borrower who has been delinquent for several months or even years, but who has not been foreclosed on, may agree to a repayment plan with the lender so that he/she will eventually be current on the mortgage and will not lose the home. The lender might also agree to modify the loan by changing the principal owed, the loan term and/or the interest rate so that the borrower can afford the monthly payments.

### **Mortgage Forbearance Agreement'**

An agreement made between a mortgage lender and delinquent borrower in which the lender agrees not to exercise its legal right to foreclose on a mortgage and the borrower agrees to a mortgage plan that will, over a certain time period, bring the borrower current on his or her payments. A forbearance agreement is not a long-term solution for delinquent borrowers; it is designed for borrowers who have temporary financial problems caused by unforeseen problems such as temporary unemployment or health problems.

### **Investopedia explains 'Mortgage Forbearance Agreement'**

Borrowers with more fundamental financial problems - such as having chosen an adjustable rate mortgage on which the interest rate has reset to a level that makes the monthly payments unaffordable - must usually seek remedies other than a forbearance agreement.

## Investopedia explains 'Mortgage Servicing Rights - MSR'

The mortgage servicer must supply an annual statement outlining the duties that were performed. In return for this assistance, the servicer is compensated with a specific fee outlined in the contract established at the beginning of the agreement. Mortgage servicing rights can be bought and sold, resulting in the transfer of any administrative obligations.

Many vertically integrated lenders today will service their mortgages in-house, which means they will also own both the loan and the servicing rights. These firms will also save money in the process.

The business of selling servicing rights for mortgages represents a large business niche, and is a multi-billion dollar industry.

## Definition of 'Servicing Fee'

A percentage of each mortgage payment made by a borrower to a mortgage servicer as compensation for keeping a record of payments, collecting and making escrow payments, passing principal and interest payments along to the note holder, etc. Servicing fees generally range from 0.25-0.5% of the remaining principal balance of the mortgage each month.

## Investopedia explains 'Servicing Fee'

In addition to earning the actual servicing fee, in most cases, mortgage servicers also benefit from being able to invest and earn interest on a borrower's escrow payments as they are collected until they are paid out to taxing authorities, insurance companies, etc. Mortgage servicing rights (MSR) trade in the secondary market much like mortgage-backed securities.

## Investopedia explains 'Mortgage-Backed Security (MBS)'

When you invest in a mortgage-backed security you are essentially lending money to a home buyer or business. An MBS is a way for a smaller regional bank to lend mortgages to its customers without having to worry about whether the customers have the assets to cover the loan. Instead, the bank acts as a middleman between the home buyer and the investment markets.

This type of security is also commonly used to redirect the interest and principal payments from the pool of mortgages to shareholders. These payments can be further broken down into different classes of securities, depending on the riskiness of different mortgages as they are classified under the MBS.

## Definition of 'Collateralized Mortgage Obligation - CMO'

A type of mortgage-backed security in which principal repayments are organized according to their maturities and into different classes based on risk. A collateralized mortgage obligation is a special purpose entity that receives the mortgage repayments and owns the mortgages it receives cash flows from (called a pool). The mortgages serve as collateral, and are organized into classes based on their risk profile. Income received from the mortgages is passed to investors based on a predetermined set of rules, and investors receive money based on the specific slice of mortgages invested in (called a tranche).

## Investopedia explains 'Collateralized Mortgage Obligation - CMO'

Collateralized mortgage obligations are complex financial instruments. Each CMO tranche can have different principal balances, interest rates, maturities and repayment risks. They are sensitive to interest rate changes as well as changes in economic conditions, such as foreclosure rates, refinance rates and the rate at which properties are sold.

Investors in CMOs look to obtain access to mortgage cash flows without having to originate or purchase a set of mortgages themselves. Organizations that purchase collateralized mortgage obligations include hedge funds, banks, insurance companies and mutual funds.

The use of collateralized debt, such as collateralized mortgage obligations and collateralized debt obligations, has been criticized as a precipitating factor in the 2007-2008 financial crisis. Rising housing prices made mortgages look like attractive investments, but market and economic conditions led to a rise in foreclosures and payment risks that financial models did not accurately predict. Because CMOs were complex and involved many different mortgages, investors were more likely to focus on income streams rather than the health of the underlying mortgages themselves.

The first CMO was created by two banks, Salomon Brothers and First Boston, for Freddie Mac in 1983.

## 'Principal'

1. The amount borrowed or the amount still owed on a loan, separate from interest.

## 'Alternative Documentation'

A documentation process designed to expedite loan approval where the lender accepts from the borrower documents such as W-2s, paycheck stubs and bank statements as verification of income made on the loan application. Confirming a borrower's information in this manner is considerably quicker than the traditional method of verifying such information with third parties.

## Investopedia explains 'Alternative Documentation'

Alternative documentation is a "full documentation" loan. In other words, income, assets, employment, etc, are documented as opposed to a "stated income stated asset" (SISA) loan. There is generally no increase in the interest rate associated with alternative documentation as there typically is with "stated" loans.

## '3-2-1 Buydown'

A type of mortgage with a series of three initial temporary-start interest rates that increase in a stair-step fashion until a permanent interest rate is reached. Lenders will charge for the temporary interest rate reductions.

A 3-2-1 buydown is sometimes used as a method to help a borrower with excess cash (but a relatively low income) to qualify for a mortgage. Or, a 3-2-1 buydown mortgage might be offered by a builder as incentive to purchase a home.

## Investopedia explains '3-2-1 Buydown'

Paying for a 3-2-1 buydown is similar to paying points on a mortgage in order to lower the interest rate. However, remember, the interest rate reductions on a 3-2-1 buydown are only temporary. A thorough analysis should be conducted to ensure that the buydown is the best economical choice for your current and future situation.

## 'Buy-Up'

Points paid by a lender to a borrower or mortgage broker for a loan with an above-market interest rate. When the points are paid to the borrower, it is known as a rebate, and must be used to defray loan settlement costs. When the points are paid to the mortgage, it is known as yield spread premium, and is part of the broker's compensation.

A buy-up is also known as "negative points".

## Investopedia explains 'Buy-Up'

Receiving a rebate in exchange for a higher interest rate can be economically advantageous to a borrower - if the borrower expects to hold the mortgage for a short period of time. The reduction in out-of-pocket loan settlement costs can offset the increased interest that will be paid out over a short-time horizon. A

thorough analysis should be made in any mortgage scenario involving buy-ups and buy-downs, or positive and negative points.

## 'Extension Risk'

The risk of a security's expected maturity lengthening in duration due to the deceleration of prepayments. Extension risk is mainly the result of rising interest rates, and is generally associated with mortgage-related securities. The opposite of extension risk is prepayment risk, which generally occurs in a declining interest rate environment, and is associated with people paying off their loans too quickly.

## Investopedia explains 'Extension Risk'

As interest rates rise, the likelihood of prepayment decreases as people will be less likely to refinance their homes. If the loans in a pool underlying a mortgage-related security are being prepaid at a slower rate, investors are unable to capitalize on higher interest rates because their investments are locked in at a lower rate for a longer period of time. As interest rates decline, however, the likelihood of prepayment increases because refinancing becomes more attractive. When a loan is refinanced, the original loan gets paid off, and investors then have to invest their proceeds at the new, lower market rate.

## 'Mortgage Excess Servicing'

The percentage of the monthly cash flow that remains after the cash flow has been divided into a coupon and principal payment for the mortgage backed securities (MBS) holder. This servicing fee typically goes to the servicer of the loan, and is possibly a guarantee fee for the underwriter of the MBS.

## Investopedia explains 'Mortgage Excess Servicing'

For example, in a typical MBS deal, if the interest rate on a mortgage is 8%, the MBS holder might receive 7.5%, the servicer of the mortgage receives 0.25% and the MBS underwriter gets 0.15%. This leaves the remaining 0.10% ( $8\% - 7.5\% - 0.25\% - 0.15\% = 0.10\%$ ) as excess servicing.

Like an MBS, excess servicing is subject to prepayment and extension risk. When excess servicing is priced, it is valued based on an estimate of how long the annuity will last. This must be estimated since it cannot be known for certain when a mortgage borrower might refinance or otherwise pay-off his or her mortgage. The value of excess servicing can change dramatically when interest rates change, because changes in current interest rates relative to the interest rate on the mortgage determine how long the annuity of excess servicing associated with that mortgage might last.

## Mortgage Putback'

The forced repurchase of a mortgage by an originator from the entity currently holding the mortgage security. A mortgage putback is most commonly required due to findings of fraudulent or faulty origination documents in which the creditworthiness of the mortgagor or appraised value of the property are misrepresented.

## Investopedia explains 'Mortgage Putback'

Following the collapse of the American real estate market in 2008 and the subsequent financial crises that followed, it was found that mortgages and mortgage-backed securities had been widely dispersed throughout the financial system and that the validity of many mortgages and documents were questionable with regards to lending standards, income verification and appraisal values. Many mortgage security holders demanded mortgage putbacks by mortgage originators who had not completed their due diligence, or in some cases had blatantly defrauded the industry.

## 'Prepayment Risk'

The risk associated with the early unscheduled return of principal on a fixed-income security. Some fixed-income securities, such as mortgage-backed securities, have embedded call options which may be exercised by the issuer, or in the case of a mortgage-backed security, the borrower.

The yield-to-maturity of such securities cannot be known for certain at the time of purchase since the cash flows are not known. When principal is returned early, future interest payments will not be paid on that part of the principal. If the bond was purchased at a premium (a price greater than 100) the bond's yield will be less than what was estimated at the time of purchase.

## Investopedia explains 'Prepayment Risk'

For a bond with an embedded call option, the higher a bond's interest rate relative to current interest rates, the higher the prepayment risk.

For example, on a mortgage-backed security, the higher the interest rate relative to current interest rates, the higher the probability that the underlying mortgages will be refinanced. Investors who pay a premium for a callable bond with a high interest rate take on prepayment risk. In addition to being highly correlated with falling interest rates, mortgage prepayments are highly correlated with rising home values, as rising home values provide incentive for borrowers to trade up in homes or use cash-out refinances, both leading to mortgage prepayments.

## Definition of 'Refinancing Risk'

1. The risk that an early unscheduled repayment of principal on mortgage-backed securities(MBS) will occur when the underlying mortgages are refinanced by borrowers. All MBS buyers assume some level of prepayments in their initial yield calculations, but an increase in the level of refinancing (which usually occurs as a result of falling interest rates) means that MBSs mature faster and will have to be reinvested at lower rates.

2. For a mortgage borrower, the risk that he or she will not be able to refinance an existing mortgage at a future date under favorable terms.

## Investopedia explains 'Refinancing Risk'

1. The prepayment estimates used to price mortgage-backed securities are made based on market conventions known as "speeds". There are two primary measures of mortgage prepayment speeds: the conditional prepayment rate and the Public Securities Association standard prepayment model.

2. Typically, refinancing risk is associated with short-term mortgage products such as hybrid ARMs and payment option ARMs. Borrowers often take on unforeseen risks when they assume that they will be able to refinance out of an existing mortgage at some planned future date - usually before a payment or interest rate reset date - to avoid an increase in their monthly payments. Interest rates might rise substantially before that date, or home price depreciation could lead to a loss of equity, which might make it hard to refinance as planned.

## 'Extension Risk'

The risk of a security's expected maturity lengthening in duration due to the deceleration of prepayments. Extension risk is mainly the result of rising interest rates, and is generally associated with mortgage-related securities. The opposite of extension risk is prepayment risk, which generally occurs in a declining interest rate environment, and is associated with people paying off their loans too quickly.

## Investopedia explains 'Extension Risk'

As interest rates rise, the likelihood of prepayment decreases as people will be less likely to refinance their homes. If the loans in a pool underlying a mortgage-related security are being prepaid at a slower rate, investors are

unable to capitalize on higher interest rates because their investments are locked in at a lower rate for a longer period of time. As interest rates decline, however, the likelihood of prepayment increases because refinancing becomes more attractive. When a loan is refinanced, the original loan gets paid off, and investors then have to invest their proceeds at the new, lower market rate.

## Contraction Risk'

The risk faced by the holder of a fixed income security when borrowers increase the rate at which they pay back the maturity value of the fixed income security. Contraction risk is a component of prepayment risk that increases as interest rates decline. This is because a decline in rates may create an incentive for the borrower to prepay all or part of the outstanding debt, which results in the life of the debt instrument being reduced. As interest rates decrease, the likelihood of prepayment increases.

## Investopedia explains 'Contraction Risk'

A financial institution that offers a mortgage at an interest rate of 5% expects to earn interest on that investment for the life of the mortgage. However, if the interest rate declines to 3%, the borrower may refinance the loan, or accelerate payments, in order to reduce the number of years that they will have to pay interest to the investor. If the borrower refinances at a lower interest rate, the total payment period is reduced, thus introducing contraction risk.

## 'Interest Rate'

The amount charged, expressed as a percentage of [principal](#), by a [lender](#) to a borrower for the use of [assets](#). Interest rates are typically noted on an annual basis, known as the [annual percentage rate](#) (APR). The assets borrowed could include, cash, [consumer goods](#), large assets, such as a vehicle or building. Interest is essentially a rental, or leasing charge to the borrower, for the asset's use. In the case of a large asset, like a vehicle or building, the interest rate is

sometimes known as the "lease rate". When the borrower is a low-risk party, they will usually be charged a low interest rate; if the borrower is considered high risk, the interest rate that they are charged will be higher.

## Investopedia explains 'Interest Rate'

Interest is charged by lenders as compensation for the loss of the asset's use. In the case of lending money, the lender could have invested the funds instead of lending them out. With lending a large asset, the lender may have been able to generate income from the asset should they have decided to use it themselves.

Using the [simple interest](#) formula:

Simple Interest =  $P$  ([principal](#))  $\times$   $I$  (annual interest rate)  $\times$   $N$  (years)

Borrowing \$1,000 at a 6% annual interest rate for 8 months means that you would owe \$40 in interest ( $1000 \times 6\% \times 8/12$ ).

Using the compound interest formula:

[Compound Interest](#) =  $P$  (principal)  $\times [ ( 1 + I(\text{interest rate})^N (\text{months}) ) - 1 ]$

Borrowing \$1,000 at a 6% annual interest rate for 8 months means that you would owe \$40.70.

The interest owed when compounding is taken into consideration is higher, because interest has been charged monthly on the principal + [accrued interest](#) from the previous months. For shorter time frames, the calculation of interest will be similar for both methods. As the lending time increases, though, the disparity between the two types of interest calculations grows.

## 'Lifetime Cap'

The maximum interest rate on an adjustable-rate mortgage (ARM) that may be charged at any point over the life of the mortgage. The lifetime cap is usually expressed as a percentage increase from an initial interest rate. For example, if a fixed period ARM has an initial fixed interest rate of 5% and a lifetime cap of 5%, the maximum interest rate that may be charged is 10%. Lifetime caps are usually part of a mortgage's interest rate cap structure which consists of initial, periodic and life caps.

## Investopedia explains 'Lifetime Cap'

Since ARMs derive their interest rates from a benchmark index, such as the London Interbank Offered Rate (LIBOR), lifetime caps limit the risks of substantial interest rate increases over the life of the mortgage. Initial and periodic caps limit the amount by which an ARM's interest rate can increase at any single interest rate adjustment date.

Some mortgages have interest rate ceilings which are similar to, and sometimes referred to as, lifetime caps. However, an interest rate ceiling is usually expressed as an absolute percentage value. For example, the contractual terms of the mortgage may state that the maximum interest rate may never exceed 15%.

## 'Interest Rate Cap Structure'

Limits to the interest rate on an adjustable-rate loan - frequently associated with a mortgage. There are several different types of interest rate cap structures including an initial, periodic and lifetime interest rate cap structure. The initial cap is a value that limits by what amount the interest can adjust at the mortgage's first interest rate adjustment date. The period cap is a value that limits by what amount the interest rate can adjust at each subsequent adjustment date. The lifetime cap limits the total amount by which the interest rate can adjust over the life of the mortgage.

explains 'Interest Rate Cap Structure'

The interest rate cap structure of a mortgage gives holders protection from large interest rate increases. For example, 5-1 fixed period ARMs usually offer the borrower a choice between a 2-2-6 or a 5-2-5 interest rate cap structure. (The first number refers to the initial cap, the second number to the periodic cap, and the third number to the lifetime cap.) If the fully indexed interest rate on the mortgage were to increase substantially before the first interest rate adjustment date, but stay below a 5% lifetime cap value, the borrower would be better off choosing the 2-2-6 interest rate cap structure. However, the dilemma to this is that borrowers can never truly be certain where interest rates will head next.

## 'Guaranteed Mortgage Certificate - GMC'

A bond backed by a pool of mortgages. These bonds are issued by the Federal Home Loan Mortgage Corporation (Freddie Mac). These bonds pay out both interest and principal on a semiannual basis.

## explains 'Guaranteed Mortgage Certificate - GMC'

The pool is made up of residential mortgages. If the mortgage is paid off at a faster than anticipated rate, the investor will still receive the entire principal amount of their investment.

## 'Mortgage Index'

The benchmark interest rate an adjustable-rate mortgage's fully indexed interest rate is based on. An adjustable-rate mortgage's interest rate, known as the fully indexed interest rate, is comprised of an index value plus a margin. The margin tends to be constant, but the index's value is variable. Several benchmark interest rates serve as mortgage indexes.

## explains 'Mortgage Index'

Some common mortgage indexes include: the prime lending rate, the one-year constant maturity treasury (CMT) value, the one-month, six-month and 12-month LIBORs, as well as the MTA index, which is a 12-month moving average of the one-year CMT index.

The index that an adjustable-rate mortgage is tied to is an important factor in the choice of a mortgage. For example, if a borrower believes that interest rates are going to rise in the future, the MTA index would be a more economical choice than the one-month LIBOR index because the moving average calculation of the MTA index creates a lag effect.

## 'Fully Indexed Interest Rate'

The interest rate on an adjustable-rate loan that is calculated by adding the margin to an index level. The interest rate on an adjustable (sometimes known as variable) rate loan is tied to a benchmark interest rate, known as an index. Popular indexes for loans are: the prime rate, LIBOR, and various U.S. Treasury bill and note rates. When calculating the fully indexed interest rate, the index level varies according to market conditions but the margin is usually a constant value.

## explains 'Fully Indexed Interest Rate'

For example, the fully indexed interest rate on an adjustable rate mortgage tied to the six-month LIBOR index with a margin of 3% would be 10% if the six-month LIBOR index were at 7%. If the six-month LIBOR index were to adjust upwards to 8%, the new fully indexed interest rate would be 11%.

For some loans, the borrower may have the option of choosing between two or more indexes to which their loan will be tied. Most popular indexes are highly

correlated with each other. In general, the lower the level of an index relative to other indexes, the higher the margin on the loan. However, the margin is frequently negotiable with the lender. The choice of the index and the margin, both of which are frequently overlooked by borrowers, can make a big difference over the life of an adjustable rate loan.

## 'Hybrid ARM'

A hybrid adjustable-rate mortgage blends the characteristics of a fixed-rate mortgage and a regular adjustable-rate mortgage. This type of mortgage will have an initial fixed interest rate period followed by an adjustable rate period. After the fixed interest rate expires, the interest rate starts to adjust based on an index plus a margin. The date at which the mortgage changes from the fixed rate to the adjustable rate is referred to as the reset date.

Also known as "fixed period ARMs".  
explains 'Hybrid ARM'

A borrower should carefully consider his or her time horizon when choosing a hybrid arm and recognize the risks associated with the reset date, or the expiration of the fixed interest rate period. If there has been a large change in interest rates, this reset could create substantially large payments; however, typically the amount by which the interest rate can adjust is subject to an interest rate cap.

## 'Transfer of Mortgage'

A transaction where either the borrower or lender assigns an existing mortgage (bank loan to purchase a residential property) from the current holder to another person or entity. Homeowners who are unable to keep current on their mortgage payments may seek a transfer so that they don't default and go into foreclosure.

Not all mortgages are eligible for transfer. In order to transfer a mortgage, the

lender will need to verify that the person or entity that will assume the mortgage has adequate income and credit history to be able to make payments in a timely manner.

## explains 'Transfer of Mortgage'

If you are not allowed to transfer a mortgage, due to the loan's underwriting, you may need to explore other options to avoid foreclosure. For example, you could work with your lender to see if it's possible to add another borrower/owner to the mortgage which would enable him/her to make payments toward the unpaid loan balance. Or you could sell the home and have a potential buyer, colleague, family member or another entity agree to make up any difference between the home's sale price and the unpaid loan balance.

## 'Power Of Sale'

A clause written into a mortgage authorizing the mortgagee (lender) to sell the property in the event of default, in order to repay the mortgage debt. As a mortgage term, power of sale is equivalent to the term foreclosure.

## explains 'Power Of Sale'

The power of sale is language added to a mortgage document that allows the lender to sell the property if the mortgage payments are not met, thereby permitting the lender to repay the mortgage debt. A property that is foreclosed is sold by the lender (usually a bank) in order to recover losses incurred by the loan default.

In addition to a mortgage term, power of sale also refers to the power expressed or implied in a trust agreement permitting the trustee to sell the investments comprising the trust.

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